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No. 261

In the Supreme Court of the United States

OCTOBER TERM, 1949

FRANK M. COBB, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The prevailing (R. 34–40) and dissenting (R. 40–43) opinions in the Tax Court are reported at 10 T. C. 380. The opinion of the Court of Appeals (R. 52–58) is reported at 173 F. 2d 711.

JURISDICTION

The judgment of the Court of Appeals was entered on April 4, 1949 (R. 52). The time for filing a petition for a writ of certiorari was extended to August 15, 1949, by order of Mr. Justice Reed, dated June 23, 1949 (R. 59). The petition for a writ of certiorari was filed on August 12,

1949. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether, in computing taxpayer's income tax for 1944, he was entitled, under Section 23 (a) (2) of the Internal Revenue Code, to deduct from gross income the amount he paid in that year as attorneys' fees in connection with a dispute as to his gift tax liability between himself and the Commissioner of Internal Revenue.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 10–14.

STATEMENT

The Tax Court found the following facts (R. 35–36):

The taxpayer resides in Cleveland, Ohio, and filed his income tax return for 1944 on January 15, 1945, with the Collector of the Eighteenth District of Ohio, at Cleveland. During 1944, taxpayer was employed as general counsel by The Cleveland Electric Illuminating Company and received $10,416 as compensation for his services rendered in that year. In addition to his salary, the taxpayer received, in 1944, net income of $16,380.32 from real estate rentals and $10,790.25 from dividends and interest (R. 35).

The taxpayer's books were kept and his 1944 return was made on a cash receipts and disbursements basis (R. 36).

Prior to December 1, 1941, the taxpayer owned an undivided one-half interest in a certain parcel of real estate located at 234–36 Euclid Avenue, Cleveland, Ohio. On or about December 1, 1941, taxpayer delivered to each of his four daughters a deed of gift transferring to each of them an undivided one-twelfth interest in fee simple of such real estate (R. 35).

The taxpayer filed a gift tax return for 1941 in which he listed such gifts to his daughters and other gifts, and paid a gift tax of $18,943.65 with the return (R. 35).

Thereafter, on July 29, 1942, the Internal Revenue Agent in Charge in Cleveland sent a letter to taxpayer proposing an adjustment of his 1941 gift tax liability which would result in a gift tax deficiency of $13,840.52 (R. 35).

On or about August 6, 1942, taxpayer employed reputable attorneys to advise him as to the merits of the proposed adjustment and to protect his interests in the matter. The attorneys prepared and filed on taxpayer's behalf a protest against the proposed adjustment. By an appropriate notice, dated November 23, 1942, the Commissioner of Internal Revenue notified taxpayer that a determination of his gift tax liability for 1941 disclosed a deficiency of $13,840.52. At taxpayer's request, his attorneys prepared and filed in the Tax Court of the United States a petition for redetermination of such deficiency. After taxpayer's attorneys had prepared for trial before the

Tax Court, a settlement was reached and on December 14, 1943, the Tax Court, pursuant to stipulation of the parties, found a deficiency in such gift tax in the amount of $6,000. On or about December 29, 1943, taxpayer paid such deficiency together with interest of $643.80 (R. 35).

Taxpayer's income in 1940 was more than $51,000. In 1940, the Euclid Avenue property yielded rent to taxpayer of approximately $20,000. In 1941, the property was occupied for the whole year and taxpayer's share of the rental was $33,500. In 1940, taxpayer was constructing a building on other property he owned which was leased subsequently to Marshall Drug Company. The indications were that his annual income would increase considerably over the amount received in 1940 (R. 36).

In order to aid his daughters and their families financially and to reduce his income taxes, taxpayer made the above-mentioned gifts to his daughters (R. 36).

Prior to making the gifts he consulted with one of his attorneys especially experienced in valuation matters with respect to the value of the four one-twelfth interests in the Euclid Avenue property to be reported in his gift tax return (R. 36).

In order to pay the 1941 gift tax deficiency of $6,000, the taxpayer sold at a loss income-producing securities. If taxpayer had been required to pay the original deficiency claimed, it would have

been necessary for him to sell additional income-producing securities (R. 36).

On January 12, 1944, taxpayer paid his attorneys the sum of $2,260 as fees for their advice and services as attorneys in connection with such gift tax dispute, which amount was reasonable for the services rendered (R. 36).

The taxpayer did not deduct the $2,260 in his income tax return for 1944, but later claimed the right to deduct it (R. 3, 34). The Commissioner disallowed such deduction (R. 37) and the Tax Court upheld him (R. 40), three judges dissenting (R. 43). The Court of Appeals affirmed (R. 58).

ARGUMENT

What the taxpayer here seeks to accomplish is not only the reversal of the considered judgments of the Tax Court and of the Court of Appeals for the Sixth Circuit, but, also, the invalidation of a Treasury Regulation which is concededly in the face of the taxpayer's claim. (Pet. 10.) But it is settled that the administrative judgment embodied in a Treasury Regulation "will not be disturbed except for weighty reasons" (*Brewster* v. *Gage*, 280 U. S. 327, 336), and there are none such for adopting "the impracticable concept that giving away property produces income to the donor, or constitutes either management or conservation of the property." (R. 58.)

When the Treasury provided, in its Regulation 111, Section 29.23 (a)–15, as amended, Appendix, *infra*, p. 14, that

> expenses paid or incurred by an individual in the determination of gift tax liability * * * are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability * * *.

it did so in the wake of this Court's decision in *Trust of Bingham* v. *Commissioner*, 325 U. S. 365. See T. D. 5513, 1946–1 Cum. Bull. 61, 62. The taxpayer now contends, however, that instead of following the principles announced in the *Bingham* case, the Treasury has rejected those principles. That view is, we think, erroneous.

It is not now contended that the expenses here involved were paid or incurred "for the production or collection of income." Reliance is placed, rather, on this Court's construction of the further provisions of Section 23 (a) (2) allowing the deduction of expenses paid or incurred "for the management, conservation, or maintenance of property held for the production of income." Appendix, *infra*, p. 10. This Court, in *Bingham*, held that "litigation expenses when they are directly connected with or proximately result from the enterprise—the management of property held for production of income" (325 U. S. at 376) may be deducted under Section 23 (a) (2). But there is no such direct connection between the expenses of resisting gift taxes and the management of the taxpayer's income producing property; nor are the expenses the proximate

result of that management. That is because the making of gifts such as were made here is in no true sense an act of management. The property which was the subject matter of the gift in 1941 had been deeded away at the time the expenses were incurred in 1944, and the taxpayer cannot be said to have been engaged in the enterprise of managing property which he had already disposed of by gift. The question in these cases being one of proximity and degree, and the Treasury Regulation having drawn a reasonable line, there is no warrant for the deduction here sought.

Expenses attendant upon the distribution to beneficiaries of trust principal and income were held deductible in the *Bingham* case only because they were "expenses of a function of 'management' of the trust property". 325 U. S. at 375. They were such only because "the duties of the trustees" included a fiduciary obligation "to distribute the income and the principal so held from time to time, and the remainder of the principal at the expiration of the trust. Performance of each of these duties [was] an integral part of carrying out the trust enterprise." *Ibid.* But, here, the taxpayer was under no obligation whatever to make gifts to his daughters. The act of donation was not an act of "management, conservation, or maintenance of property held for the production of income". Section 23 (a) (2); see R. 57. Hence, the taxpayer's reliance on the *Bingham* decision is misplaced.

If, as the taxpayer states, "the contesting" of the gift tax deficiency "was a separate and independent act of 'management' from that of making the gift" (Pet. 11), the only income producing property being "managed" must have been not the property he gave but that which he retained and would have used to pay the greater deficiency than that finally determined. And the relationship between the expenses and the retained property is not such as to satisfy the test of "proximate result" announced in the *Bingham* case. In *Bingham,* this court ruled that the "Tax Court could find as a matter of fact * * * that the expenses of contesting the income taxes were a proximate result of the holding of the property for income." 325 U. S. at 376. But here, the expenses were not at all attendant upon the production of income; they were, on the contrary, directly connected with the profitless separation from the taxpayer of some of his property. The expense of resisting the Commissioner's claim had the object, in the taxpayer's words, of cancelling "the gift tax lien on the donated property." Pet. 11. Taxpayer cannot resist liens on donated property and then seek to attribute the cost of resistance to retained property.[1] The expenses here involved were

[1] Whether expenses connected with resistance to a lien on retained property would be deductible would depend, of course, on the nature and origin of the liability giving rise to the lien. Cf. R. 38–39.

"personal" or "family expenses" expressly made non-deductible by Section 24 (a) (1). Appendix, *infra*, p. 11.

CONCLUSION

The decision of the court below is required by the Treasury Regulation and it is correct. There is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses; * * *;

* * * * *

(26 U. S. C. 1946 ed., Sec. 24.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23 (a)–15. *Nontrade or Nonbusiness Expenses.*

(a) *In general.*—Subject to the qualifications and limitations in chapter 1 and particularly in section 24, an expense may be deducted under section 23 (a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

The term "income" for the purpose of section 23 (a) (2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from

which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. Similarly, ordinary and necessary expenses incurred in the management, conservation or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses incurred in managing, conserving, or maintaining property held for investment may be deductible under this provision even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on transactions, which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23 (a) (2), must be "ordinary and necessary," which presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or main-

tenance of property held for the production of income.

(*b*) [as amended by T. D. 5513, 1946–1 Cum. Bull. 61, 62] Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24. * * * Nor does section 23 (a) (2) allow any expenses which are disallowed by any of the provisions of chapter 1.

Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

* * * * *

* * * Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become deductible, however, by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses paid or incurred by an individual in the determination of gift tax liability, except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income.

* * * * *

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